

Office of the State Auditor
Division of State Audit

North Dakota Lottery
Bismarck, North Dakota

Audit Report for the
Year Ended June 30, 2004
Client Code 125.1

Robert R. Peterson
State Auditor



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INDEPENDENT AUDITOR'S REPORT

Honorable John Hoeven, Governor
Members of the Legislative Assembly

Chuck Keller, Director
North Dakota Lottery

We have audited the accompanying financial statements of the North Dakota Lottery, a division of the Office of the Attorney General, State of North Dakota, as of and for the year ended June 30, 2004, which collectively comprise the Lottery's basic financial statements as listed in the table of contents. These financial statements are the responsibility of North Dakota Lottery management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

As discussed in Note 1, the financial statements of the North Dakota Lottery are intended to present the financial position, and the changes in financial position and cash flows of only that portion of the business-type activities of the State of North Dakota that are attributable to the transactions of the North Dakota Lottery. They do not purport to, and do not, present fairly the financial position of the State of North Dakota as of June 30, 2004, and the changes in its financial position and its cash flows, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the North Dakota Lottery, as of June 30, 2004, and the respective changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 30, 2004, on our consideration of the North Dakota Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 through 7 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Robert R. Peterson
State Auditor
September 30, 2004

NORTH DAKOTA LOTTERY

MANAGEMENT'S DISCUSSION AND ANALYSIS

For the Fiscal Year Ended June 30, 2004

This Management's Discussion and Analysis is for readers of the Lottery's financial statements and is an overview of the Lottery's financial activity for the fiscal year ended June 30, 2004. This analysis is to be considered in conjunction with the financial statements to provide an objective analysis of the Lottery's financial activity based on facts, decisions, and conditions that presently face the director.

Understanding the Lottery's Financial Statements

The Lottery, a division of the Office of Attorney General, is accounted for as an enterprise fund that reports all income, expense, assets, and liabilities using the accrual basis of accounting, like a private business entity. In accordance with generally accepted accounting principles, this report consists of three financial statements and explanatory notes. The financial statements are: 1) Statement of Revenues, Expenses and Changes in Net Assets; 2) Statement of Net Assets; and 3) Statement of Cash Flows. The financial statements are designed to highlight the Lottery's operating activity and provide a snapshot of its financial condition.

A vital factor of the Lottery's financial statements is a statutory requirement that the Lottery transfer all net proceeds, less the amount allocated to the compulsive gambling prevention and treatment fund and a holdback of any reserve funds the director may need for continuing operations, to the state treasurer on at least an annual basis for deposit in the state general fund. Accordingly, the primary focus of these financial statements is to determine the net proceeds that are available for transfer to the state general fund. It is also important to note that most financial statement balances have a direct or indirect relationship to revenue. As lottery sales increase, the amount to be transferred to the state general fund would also increase. Similarly, as lottery sales increase, there is a direct increase in prizes, retailer commissions, and vendor fees.

Most of the assets included on the Statements of Net Assets represent current amounts such as cash and accounts receivable from lottery retailers. Most liabilities represent current prizes, including prizes payable in North Dakota, prize reserve pool amounts payable to the Multi-State Lottery Association (MUSL), and amount due the state general fund.

Financial Highlights

The Lottery is unique compared to all other state lotteries because it may only conduct multi-state online games. The constitution restricts the Lottery to multi-state games. The law restricts the Lottery to online games. Therefore, the Lottery may not conduct common in-state lotto games, instant ticket games, or pick 3 or 4 numbers games.

The Lottery is considered an immature lottery because it is new, a novelty, and has few games. The Lottery enjoys broad public support in the play of its games and has achieved exceptional success in sales and net proceeds during its honeymoon period. The challenge facing the Lottery is to sustain and increase sales growth and net

proceeds by actively promoting sales of tickets for present and new games in a competitive environment.

The Lottery launched its first game of Powerball on March 25, 2004, and launched its second game of Hot Lotto on June 24, 2004.

Total prizes on winning tickets were \$2,790,398, including prizes payable to set prizes (other than grand prizes) in North Dakota of \$1,216,192 and prizes payable to the MUSL to fund grand prizes of \$1,574,206.

When the Lottery adds a new game, a greater portion of each dollar of sales goes toward net proceeds since operating expenses like salaries and fringe benefits, travel, telephone, and MUSL board dues are generally fixed and would not necessarily increase incremental to sales. Some operating expenses like advertising & marketing would increase. However, there are variable expenses that have a direct incremental relationship to sales like prizes, retailer commissions, and vendor fees.

The Lottery's operating expenses are minimized because the Lottery blueprinted its organizational structure, functions, and gaming system features to optimize efficiency.

The Lottery earned \$1,665,952 of net proceeds that will be distributed as follows:

1. \$94,007 to the MUSL for the Lottery's Powerball Set-Prize Reserve Pool and Hot Lotto Prize Reserve Pool;
2. \$139,511 to the state treasurer for deposit in the Compulsive Gambling Prevention and Treatment Fund. By law, the Lottery must transfer 5% of the gross profit, up to \$400,000, to this fund for the 2003-05 biennium. The Lottery anticipates transferring the entire \$400,000 to the fund in the biennium; and
3. \$1,432,434 to the state general fund. It was initially projected that the Lottery would generate \$1,431,000 for the 2003-05 biennium.

The Lottery's updated estimate for state general fund revenue is \$4,507,683 for the 2003-05 biennium and \$7,110,633 for the 2005-07 biennium.

Overview of the Financial Statements

Statement of Net Assets Summary:

Total Current Assets	\$2,366,402
Total Noncurrent Assets	78,259
Total Assets	<u>2,444,661</u>
Total Current Liabilities	2,301,196
Total Noncurrent Liabilities	48,024
Total Liabilities	<u>2,349,220</u>
Total Unrestricted Assets	<u>\$ 95,441</u>

Statement of Revenues, Expenses, and Changes in Net Assets Summary:

Total Operating Revenue	\$6,036,566
Total Operating Expense	4,373,228
Operating Income	<u>\$1,663,338</u>
Total Non-Operating Income	2,614
Net Proceeds before Operating Transfers	<u>\$1,665,952</u>
Total Transfers to Other Funds	1,570,511
Change in Net Assets	<u>\$ 95,441</u>
Total Net Assets, Beginning of Year	0
Total Net Assets, End of Year	<u><u>\$ 95,441</u></u>

Revenue:

Powerball Ticket Sales	\$5,655,172
Hot Lotto Ticket Sales	113,430
Total Ticket Sales	<u>\$5,768,602</u>
Other Operating Revenue	267,964
Total Revenue	<u><u>\$6,036,566</u></u>

Expenses:

Prize Expense	\$2,790,398
Retailer Commissions	288,430
Operating Expenses	<u>1,294,400</u>
Total Expenses	<u><u>\$4,373,228</u></u>

Net Proceeds:

Net Proceeds before Operating Transfers	\$1,665,952
Percent of Net Proceeds to Total Operating Revenue	27.6%

Online Gaming System

The Lottery executed an eight-year contract, effective March 25, 2004, with Scientific Games International, Inc. (Scientific Games) to provide the Lottery with online and secondary online gaming systems hardware, game management system software (GMS), satellite-based retailer telecommunications network, four hundred lottery terminals, electronic scrolling, and logo backlit signs, primary and secondary internal control systems (ICS), and five field technicians to provide service to lottery retailers. The Lottery does not own any of this equipment. The GMS manages retailers and tracks and controls the sale of tickets, validation of winning tickets, and payments on winning tickets. The ICS's are independent databases of all retailer sales transactions that are controlled only by the Lottery, and are used for each draw to determine the number of winning tickets, by prize value.

Potential Factors Affecting Future Operations

By law, the Lottery is restricted to multi-state online games. The Lottery must partner with one or more other government-authorized lotteries to conduct a game. This

restriction generally limits the Lottery to games sponsored by the MUSL. The MUSL may not have a broad range of games available to fulfill the Lottery's desired product mix. Should the MUSL disband, although it is not anticipated, the Lottery may not have a source of games to operate.

The Lottery's online and secondary online gaming systems are co-located with the primary and secondary online gaming systems of the Montana Lottery at a computer data center located in Helena, MT. The computer data center is owned by Scientific Games which is the gaming system vendor for both the Montana Lottery and North Dakota Lottery. The Montana Lottery's contract with Scientific Games expires in March 2007. Should the Montana Lottery not renew its online contract with Scientific Games, Scientific Games is responsible, if necessary, for re-locating the North Dakota Lottery's online and secondary online gaming systems to another computer data center to ensure there is no interruption of service to the Lottery.

Looking Ahead

The Lottery's primary goal is to maximize revenue for the state general fund. To accomplish this, the Lottery must offer exciting and attractive games for players to play, license retailers that are in convenient locations to sell tickets, create effective annual marketing plans, and control operating expenses. Attractive games include a broad range of player odds and minimum jackpot prizes. The odds on a player winning any cash prize on a one dollar play may eventually range from one in three and one-half to one in thirty-six. And, the minimum jackpot may range from twenty thousand dollars to ten million dollars. The product mix may include up to six games.

Total sales of a game are dramatically affected by the size of the game's jackpot. Larger jackpots generate higher sales. However, larger jackpots cannot be predicted or counted upon. Therefore, a variety of games is necessary to attract players.

The Lottery has 398 licensed retailers located in 120 towns and cities, including all fifty-three counties. This is about 1 lottery terminal for each 1,592 residents.

During the fiscal year ending June 30, 2005, the Lottery plans to:

1. Launch its third game "Wild Card 2" on September 23, 2004; and
2. Enable players to buy gift certificates that may be redeemed for tickets.

During the 2005-07 biennium, the Lottery plans to:

1. Launch at least two new games;
2. Enable players to buy subscriptions to purchase tickets for draws for future periods of 13, 26, or 52 weeks; and
3. Conduct public and player surveys about the Lottery.

Compulsive Gambling Prevention and Treatment Fund

By law, five percent of the gross profit generated from the sale of tickets, not to exceed four hundred thousand dollars per biennium, must be transferred to the compulsive gambling and prevention and treatment fund.

The Lottery is sensitive to problem gambling and encourages players to play responsibly.

Contacting the Lottery

If a person has a question on any information in this report or desires additional information, the person should write to: North Dakota Lottery; Office of Attorney General; 600 E Blvd. Ave. - Dept. 125; Bismarck, ND 58505-0040.

North Dakota Lottery
Statement of Net Assets
For the Fiscal Year Ended June 30, 2004

	<u>June 30, 2004</u>
Assets:	
Current Assets:	
Cash and Cash Equivalents	\$ 2,213,319
Investments	1,000
Accounts Receivable	147,257
Due from Other State Funds	1,332
Prepaid Expenses	3,494
Total Current Assets	<u>2,366,402</u>
Noncurrent Assets:	
Reserves on Deposit	<u>78,259</u>
Total Noncurrent Assets	<u>78,259</u>
Total Assets	<u>2,444,661</u>
Liabilities:	
Current Liabilities:	
Accounts Payable	404,400
Due to Other State Funds	1,572,323
Accrued Payroll	28,985
Prizes Payable	194,444
Deferred Revenue	69,888
Retailer Security Deposits	7,000
Compensated Absences Payable	24,156
Total Current Liabilities	<u>2,301,196</u>
Noncurrent Liabilities:	
Compensated Absences Payable	<u>48,024</u>
Total Noncurrent Liabilities	<u>48,024</u>
Total Liabilities	<u>2,349,220</u>
Net Assets:	
Unrestricted	95,441
Total Net Assets	<u><u>\$ 95,441</u></u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

NORTH DAKOTA LOTTERY
Statement of Revenues, Expenses and Changes in Net Assets
For the Fiscal Year Ended June 30, 2004

	<u>June 30, 2004</u>
Operating Revenues:	
Ticket Sales	\$ 5,768,602
Other Operating Revenue	<u>267,964</u>
Total Operating Revenues	<u>6,036,566</u>
 Operating Expenses:	
Prize Expense	2,790,398
Retailer Commissions	288,430
Contractual Services Expense	606,060
Marketing	237,417
Salaries and Benefits	314,037
Operating	<u>136,886</u>
Total Operating Expenses	<u>4,373,228</u>
 Operating Income	<u>1,663,338</u>
 Nonoperating Revenues:	
Interest Income	<u>2,614</u>
Total Nonoperating Revenues	<u>2,614</u>
 Income Before Transfers	<u>1,665,952</u>
 Transfers to Other Funds:	
Compulsive Gambling Fund	139,511
State General Fund	<u>1,431,000</u>
Total Transfers to Other Funds	<u>1,570,511</u>
 Change in Net Assets	95,441
Total Net Assets – Beginning of Year	<u>0</u>
Total Net Assets – End of Year	<u><u>\$ 95,441</u></u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

NORTH DAKOTA LOTTERY
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2004

	<u>June 30, 2004</u>
Cash Flows from Operating Activities:	
Ticket Sales	\$ 4,627,373
Other Revenues	273,964
Paid to Prize Winners	(221,536)
Paid to Vendors	(2,176,771)
Paid to Employees	(212,302)
Reserves on Deposit	(78,259)
Net Cash Provided by Operating Activities	<u>2,212,469</u>
Cash Flows from Investing Activities:	
Interest Income	<u>850</u>
Net Cash Provided by Investing Activities	<u>850</u>
Cash and Cash Equivalents at Beginning of Year	<u>0</u>
Cash and Cash Equivalents at End of Year	<u><u>\$ 2,213,319</u></u>
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:	
Operating Income	1,663,338
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:	
Changes in Assets and Liabilities:	
(Increase) Decrease in Accounts Receivable	(146,746)
(Increase) Decrease in Investments	(1,000)
(Increase) Decrease in Due from Other State Funds	(1,332)
(Increase) Decrease in Prepaid Expenses	(3,494)
(Increase) Decrease in Reserves on Deposit	(78,259)
Increase (Decrease) in Accounts Payable	405,653
Increase (Decrease) in Accrued Payroll	28,985
Increase (Decrease) in Compensated Absences Payable	72,180
Increase (Decrease) in Prizes Payable	194,444
Increase (Decrease) in Due to Other State Funds	1,812
Increase (Decrease) in Other Current Liabilities	76,888
Total Adjustments	<u>549,131</u>
Net Cash Provided by Operating Activities	<u><u>\$ 2,212,469</u></u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

NORTH DAKOTA LOTTERY

Notes to the Financial Statements

For the Fiscal Year Ended June 30, 2004

Note 1. Summary of Significant Accounting Policies

Organization

On November 5, 2002, North Dakota citizens approved a constitutional amendment that enables the state to participate in multi-state lottery games. The 2003 Legislative Assembly passed House Bill No. 1243 that became law on April 4, 2003. This law, chapter 53-12 (Lottery) of the North Dakota Century Code, created the North Dakota Lottery as a division within the Office of Attorney General. The law restricts the Lottery to multi-state online games. In-state lotto games, instant ticket games, and pick 3 or 4 numbers games are prohibited.

The mission of the Lottery is to maximize net proceeds for the benefit of the state by promoting entertaining games, providing quality customer service to retailers and players, achieving the highest standards of integrity, security, and accountability, and maintaining public trust.

The Lottery is our state's newest government-sponsored business enterprise. The Lottery manages, regulates, and promotes this business. As a business, the Lottery must be profitable in the eyes of the legislature. To be profitable, the Lottery must prosper, have a positive public image, and players must be confident that games are fair and honest. The success of the Lottery will depend on how well the Lottery is managed, the variety of games that are available to players, and how effective games are promoted.

The Lottery is a member of the Multi-State Lottery Association (MUSL). The Lottery has been authorized to conduct the games of Powerball, including Power Play, Hot Lotto, and Wild Card 2. The Powerball matrix is a 5 of 53 and 1 of 42 game. Powerball was launched on March 25, 2004. The Lottery's first day Powerball ticket sales of \$148,350 ranked it, on a per capita basis, as the most successful Powerball launch in the nation. The Hot Lotto matrix is a 5 of 39 and 1 of 19 game. Hot Lotto was launched on June 24, 2004. Wild Card 2 is scheduled to be launched on September 23, 2004. Drawings for Powerball and Hot Lotto are held each Wednesday and Saturday evenings starting at 9:58 p.m. C.S.T.

To play the Power Play option on a Powerball ticket, a player pays an additional one dollar per play for an opportunity to multiply the player's set prize (excluding the grand prize) by 2, 3, 4, or 5. Before each Powerball drawing, the Power Play prize multiplier number is selected for that draw. In 40% of the time, the prize multiplier should be 5. The Lottery plans to launch additional games within the next few years to provide players with games that have a variety of minimum jackpot amounts and odds of winning.

Reporting Entity

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, the Lottery should include all component units over which the Lottery exercises such aspects as (1) appointing a voting majority of an organization's governing body and (2) has the ability to impose its will on that organization or (3) the potential for the organization to provide specific financial benefits to, or impose specific burdens on, the Lottery.

Based on the criteria of GASB Statement No. 14, no organization was determined to be part of the Lottery as a reporting entity. The Lottery is a division of the Office of Attorney General which is part of the primary government of the State of North Dakota.

Basis of Accounting and Measurement Focus

The Lottery's activity is accounted for as a proprietary type enterprise fund for the State of North Dakota. A proprietary fund is accounted for using the accrual basis of accounting. Revenues are recognized when they are earned and expenses are recognized when they are incurred.

An enterprise fund is used to account for an activity that is financed and operated in a manner similar to a private business enterprise where the costs of providing goods or services to the public on a continuing basis are financed through the sale of those goods or services. The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. An enterprise fund is accounted for by using the economic resources measurement focus in which all assets and liabilities associated with the operation of the funds are included on the statement of net assets. Net assets are segregated into investments in capital assets and restricted and unrestricted components. The statement of revenues, expenses and changes in net assets present increases, like revenues, and decreases, like expenses, in total net assets. The statement of cash flows presents the cash flows for operating, investing, and non-capital financing activities.

The lottery law prescribes that except for the initial startup funding to the Lottery, general fund monies of the state may not be used or obligated to pay expenses or prizes of the Lottery.

Accounting Standards

The Lottery follows the pronouncements of the GASB, which is the nationally accepted standard-setting body for establishing generally accepted accounting principles for governmental entities. In accordance with GASB Statement No. 20, the Lottery follows all applicable GASB Pronouncements and Financial Accounting Standards Board pronouncements issued on or before November 30, 1989 unless those pronouncements conflict with GASB pronouncements.

The preparation of financial statements in conformity with generally accounting principles requires the director to make estimates and presumptions that affect reported amounts of assets, liabilities, income, and expenses. Actual results could differ from those estimates.

Operating and Nonoperating Revenues

A enterprise fund distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the proprietary fund's principal ongoing operation. The principal operating revenue of the Lottery is sales of tickets. Operating expenses of the Lottery include prizes, retailer commissions, contractual services, marketing, and salaries and fringe benefits. All revenue and expenses not meeting the criteria are reported as nonoperating income and expenses.

Cash and Cash Equivalents

Cash and cash equivalents are defined as deposits with the Bank of North Dakota and the State Treasurer. The Lottery does not invest in marketable securities.

Retailer Security Deposits

If retailers have an unsatisfactory credit rating, the Lottery requires those retailers to provide the Lottery a security deposit to protect the Lottery from bad debts. Security may be in the form of a performance bond, deposit in cash, an irrevocable letter of credit, or a certificate of deposit. Security deposits in the form of checks or certificates of deposit are classified as assets. Security deposits in the form of letters of credit or performance bonds are classified as collateral.

Accounts Receivable

Accounts receivable primarily represents lottery funds due from retailers for ticket sales, less commissions and prizes on winning tickets paid by retailers. Lottery funds are collected weekly through electronic funds transfer by the Lottery from retailers' bank accounts. The Lottery has not incurred and does not project any bad debts.

Reserves on Deposit

The Lottery has \$78,259 on deposit with the MUSL related to the Powerball Set-Prize Reserve Pool. See Note 6.

Prepaid Expenses

Prepaid expenses of \$3,494 are retailer commissions on future sales.

Furniture, Fixtures, and Equipment

The Lottery has no capitalized furniture, fixtures, or equipment. A fixed asset is capitalized if it has a useful economic life of more than one year, is tangible, and has a unit cost of \$5,000 or more. Depreciation would be computed using the straight-line method over the asset's estimated useful economic life.

Prizes

Prize expense is recorded based on actual drawing results.

Prizes payable represents the difference between the amount of prize expense recognized and actual prizes paid.

Players may redeem winning tickets for up to 180 days after the draw for the game. As of June 30, 2004, unclaimed prizes were \$194,444. No prizes had yet expired.

Deferred Revenue

A liability has been recorded for lottery tickets sold on or before June 30, 2004 on multiple draw tickets that contain plays for future draws that will occur after June 30, 2004. The amount related to future sales of \$69,888 is classified as deferred revenue.

Interfund Balances and Transfers

At June 30, 2004, the Lottery had nominal accounts payables and receivables involving normal business expenses with several state agencies and had net proceeds due to be transferred to two state funds.

By law, the net proceeds of the Lottery, less the amount allocated to the compulsive gambling prevention and treatment fund and a holdback of any reserve funds the director may need for continuing operations, must be transferred to the state treasurer on at least an annual basis for deposit in the state general fund. By law, five percent of the Lottery's gross profit, up to four hundred thousand dollars during the 2003-05 biennium, must be transferred to the compulsive gambling prevention and treatment fund. The reserve funds held by the director are funds that are required to be transferred to the MUSL for prize reserve pools. The balance of the net proceeds is transferred to the state general fund.

Retailer Commissions

Lottery retailers that sell tickets receive a five percent commission on each ticket sold or distributed to players. The Lottery does not offer retailers a commission on redeemed winning tickets or bonuses for sales incentives or for selling a jackpot prize winning ticket. Retailer commissions were \$288,430.

Marketing and Advertising

Costs incurred for developing creative, including point-of-sale items, research, and media advertising are expensed when incurred which generally is when point-of-sale items are first distributed to retailers or advertising first takes place.

Accumulated Unpaid Vacation, Sick Pay, and Compensatory Pay

Annual leave and sick leave are a part of permanent employees' compensation as set forth in Section 54-06-14 of the North Dakota Century Code. Annual leave is earned based on tenure of employment, within a range of a minimum of one working day per month of employment, to a maximum of two working days per month of employment, to be fixed by rules and regulations adopted by the employing unit. In general, accrued annual leave cannot exceed 30 days at each fiscal year-end, as set by the Office of Attorney General. Employees are paid for unused annual leave upon termination or retirement.

Sick leave is earned at the rate of one working day per month of employment. There are no limitations on the amount of sick leave that an employee can accumulate. Employees who have ten continuous years of service are paid one-tenth of their accumulated sick leave upon termination or retirement under chapter 54-52 of the North Dakota Century Code. A liability is recognized for that portion of accumulated sick leave benefits that is estimated will be taken as required by the GASB Statement No. 16, *Accounting for Compensated Absences*.

Compensatory leave is earned by employees who work overtime each week in accordance with the Office of Attorney General's policy. Generally, upon termination or retirement, employees are not eligible to receive compensation for their compensatory leave balances.

Note 2. Compensated Absences

A summary of compensated absences follows:

Beginning balance, July 1, 2003	\$ 0
Addition	72,180
Reduction	0
Ending balance, June 30, 2004	<u>\$ 72,180</u>
Amount payable within one year	<u>\$ 24,156</u>

Note 3. Due to / Due from Other State Funds

At June 30, 2004, accounts payable due to several state agencies and transfers of net proceeds due to two state funds are:

Due to the Department of Transportation	\$ 139
Due to the Information Technology Department	677
Due to the Office of Management & Budget	447
Due to the Office of Attorney General	60
Due to ND Public Employees Retirement System	489
Due to the State General Fund	1,431,000
Due to the Compulsive Gambling Fund	139,511
Total	<u>\$1,572,323</u>

The total amount of \$1,572,323 was paid or transferred by July 27, 2004.

Due from other state funds are due from the Office of Attorney General in the amount of \$1,332.

Note 4. Unrestricted Net Assets

The Lottery's unrestricted net assets of \$95,441 will be distributed as follows:

State General Fund	\$ 1,434
MUSL Powerball Set Prize Reserve Pool	\$90,604
MUSL Hot Lotto Prize Reserve Pool	\$ 3,403

Note 5. Employee Pension Plan

The Office of Attorney General participates in the North Dakota Public Employees' Retirement System (NDPERS) administered by the State of North Dakota. The following is a brief description of the plan.

NDPERS is a cost-sharing multiple-employer defined benefit pension plan covering substantially all classified employees of the Office of Attorney General. The plan provides retirement, disability and death benefits. If an active employee passes away with less than three years of credited service, a death benefit equal to the value of the employee's accumulated contributions, plus interest, is paid to the employee's beneficiary. If the employee has earned more than three years of credited service, the surviving spouse is entitled to a single payment refund, life-time monthly payments in an amount equal to 50% of the employee's accrued normal retirement benefit, or 60 monthly payments equal to the employee's accrued normal retirement benefit calculated as if the employee were age 65 the day before death occurred or monthly payments in an amount equal to the employees' accrued 100% joint and survivor retirement benefit if the member had reached normal retirement age prior to date of death. If the surviving spouse passes away, before the employee's accumulated pension benefits are paid, the balance is payable to the surviving spouse's designated beneficiary.

Eligible employees who become totally disabled after a minimum of 180 days of service receive monthly disability benefits that are equal to 25% of their final average salary with a minimum benefit of \$100. To qualify under this section, the employee must meet the criteria established by the Retirement Board for being considered totally disabled.

Employees are entitled to unreduced monthly pension benefits equal to 2.00% of their final average salary for each year of service beginning when the sum of age and years of credited service equal or exceed 85, or at normal retirement age (65). The plan permits early retirement at ages 55-65, with three or more years of service.

Benefit and contribution provisions are administered in accordance with chapter 54-52 of the North Dakota Century Code. This state statute requires that 4% of the participant's salary be contributed to the plan by either the employee or by the employer under a "salary reduction" agreement. The Office of Attorney General has implemented a salary reduction agreement and is currently contributing the employees share. The Office of Attorney General is required to contribute 4.12% of each participants salary as the employer's share. The required contributions are determined using an entry age normal actuarial funding method. The North Dakota Retirement Board was created by the State Legislature and is the governing authority of NDPERS. The Office of Attorney General required an actual contribution to NDPERS for the fiscal year ended June 30, 2004 of \$14,738.

NDPERS issues a publicly available financial report that includes financial statements and the required supplementary information for NDPERS. That report may be obtained by writing to NDPERS; 400 East Broadway, Suite 505, PO Box 1214, Bismarck, ND 58502-1214.

Note 6. Multi-State Lottery Association

The Lottery is a member of the MUSL which administers the Powerball, Hot Lotto, and Wild Card 2 lottery games on behalf of member lotteries. The Lottery makes weekly wire transfers to the MUSL in an amount equal to each game's prize structure, less the amount retained for set-prizes (low tier prizes) to be paid by the Lottery. If the liability for set prizes exceeds the game's prize structure, funds may be transferred from MUSL to the member lottery.

The prize structure for Powerball and Hot Lotto is 50 percent of each game's drawing period's sales. However, the Powerball product group has authorized new member lotteries to offset 2% of sales (as a reduction in the 50% prize pool) as payment toward the member lotteries' Prize Reserve and Set-Prize Reserve. The Hot Lotto product group has authorized all of its member lotteries to offset up to 3% of sales (as a reduction in the 50% prize pool) as payment toward the member lotteries' Grand Prize Reserve Pool. For Hot Lotto, after the annuitized grand prize exceeds \$2 million, the Lottery's contribution to the Grand Prize Reserve Pool is 1% of sales. Also, for Hot Lotto, an additional 2% of sales (as a further reduction in the 50% prize pool) are placed in the Grand Prize Reserve Pool after the annuitized grand prize exceeds \$5 million.

For Powerball and Hot Lotto grand prizes, winning players can choose lump sum cash payments or receive grand prizes in annual installments. For Powerball, 30 annual payments are made. For Hot Lotto, 25 annual payments are made. On or near the annual installment date, the MUSL would provide the member lottery with the amount owed to the winning player and the member lottery would make the actual payment.

The MUSL maintains prize reserve pools for each product group as contingency reserves to protect from unforeseen prize liabilities. The funds in these reserve pools are used at the discretion of the product groups. The funds are refundable to member lotteries if the MUSL disbands or if a member lottery leaves the MUSL. If a member lottery leaves the MUSL, there is a one-year waiting period before the member lottery's share of the prize reserve pools is distributed.

The MUSL has a "Pooled Prize Trust" that is divided into separate pools to be available for each product group that may elect to have one or more of the pools, including:

The MUSL "Grand Prize Pool" is used to buy a game's grand prize. The source of this money is the member lotteries' share of the grand prize that they transfer to the MUSL. The funds are held until the grand prize is awarded.

The MUSL "Set-Prize Reserve Pool" is used to guarantee the payment of set cash prizes (low tier prizes). The source of this money is a deduction from the member lotteries' grand prize percentage.

The MUSL "Set-Aside Pool" is used to guarantee payment of the minimum grand prize for the Powerball and Hot Lotto games. Powerball has a minimum grand prize of \$10 million. Hot Lotto has a minimum grand prize of \$1 million. The source of this money is a 2% deduction from the grand prize percentage.

The MUSL “Grand Prize Reserve Pool” is established for each product group that elects to establish a Prize Reserve Pool. This account is to guarantee the payment of valid, but unanticipated, grand prize claims that may result from an online gaming system error or for any other reason. The source of this money is a percentage deduction from the grand prize percentage, which is in effect whenever the balance of the account is below the maximum amount set by the game group.

The MUSL “Unreserved Account” is funded from interest earnings of the Grand Prize Pool, Set-Prize Reserve Pool, Grand Prize Reserve Pool, the Unreserved Account, and any trading profits realized from the bond portfolio. The earnings paid to this account are considered to be distributions to the member lotteries. A member lottery’s Unreserved Account can be used to offset the member’s operating expenses, including its share of budget dues, game promotions approved by the MUSL’s Board, research, and legal expenses.

The MUSL “Winners Trusts” are legal trusts used for games with annuitized prizes. If a grand prize winner selects annual installments, the MUSL buys United States zero coupon bonds in the name of the member lottery that becomes the beneficiary. These trusts hold securities used to fund the MUSL’s payment of cash to the member lotteries so the lotteries can, as obligated, pay winning players when annuitized payments are due. The source of this money is a product group’s Grand Prize Pool. The assets and related liabilities are reflected in the MUSL’s financial statements and, therefore, are not reflected in the Lottery’s financial statements.

Upon becoming a member of the MUSL Board and joining the Powerball and Hot Lotto product groups, the Lottery is responsible for its pro-rated share of the MUSL Board dues and Powerball and Hot Lotto product group dues, and equipment cost for the period ended June 30, 2004, as follows:

MUSL Board dues	\$13,876
MUSL Powerball product group dues	\$3,473
MUSL Hot Lotto product group dues	\$122
MUSL equipment cost	\$1,932

Also, the Lottery is responsible for its pro-rated share of the MUSL product group prize reserve pools, and Unreserved Account, as follows:

The MUSL Powerball Set-Prize Reserve Pool account balance and the Lottery’s share of that balance as of June 30, 2004 are:

MUSL Set-Prize Reserve Pool account balance	\$25,582,357
Lottery’s share of the MUSL’s account balance (on deposit)	\$78,259
Lottery’s present amount due the MUSL	\$12,345
Lottery’s future amount due the MUSL	\$101,358

The MUSL Powerball Grand Prize Reserve Pool account balance and the Lottery's share of that balance as of June 30, 2004 are:

MUSL Grand Prize Reserve Pool account balance	\$68,267,775
Lottery's share of the MUSL's account balance	\$0
Lottery's present amount due the MUSL	\$0
Lottery's future amount due the MUSL	\$575,886

The MUSL Hot Lotto Grand Prize Reserve Pool account balance and the Lottery's share of that balance as of June 30, 2004 are:

MUSL Prize Reserve Pool account balance	\$199,909
Lottery's share of the MUSL's account balance	\$0
Lottery's present amount due the MUSL	\$3,403
Lottery's future amount due the MUSL	\$0

The MUSL Unreserved Account balance and the Lottery's share of that balance as of June 30, 2004 are:

MUSL Unreserved Account	\$9,737,349
Lottery's share of the MUSL's account balance	(\$18,028)

Note 7. Contracts

The Lottery entered into a contract with:

1. Scientific Games International, Inc. of Alpharetta, GA on February 3, 2004. The vendor provides an online lottery gaming system and related services through March 24, 2012, with a possible extension through March 24, 2014;
2. H2M of Fargo, ND on February 2, 2004. The vendor provides marketing and related services through June 30, 2005, with a possible extension through June 30, 2007; and
3. A & U Security, LLC, of Helena, MT on March 8, 2004. The vendor provides standby services and, if necessary, security of the Scientific Games International, Inc.'s computer data center on days of the drawings through March 26, 2007.

Note 8. Credit Risk Disclosure

At June 30, 2004, cash and cash equivalents, by account, were:

Operating Account	\$1,738,961
Prize Payment Account	474,358
Total	<u>\$2,213,319</u>

The Lottery is required to maintain its operating and prize payment accounts at the Bank of North Dakota (BND), a state-owned bank. The book and carrying value of these deposits is \$2,213,319. Since all the funds are on deposit at BND, they are not subject

to credit risk classification. The deposited amounts are guaranteed by the State of North Dakota according to section 6-09-10 of the North Dakota Century Code.

Note 9. Risk management

The Lottery is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Lottery, as a division of the Office of Attorney General, participates in the same funds/pools established by the state for risk management issues, including:

The 1995 Legislative Assembly established the Risk Management Fund (RMF), an internal service fund, to provide a self-insurance vehicle for funding the liability exposures of state agencies resulting from the elimination of the State's sovereign immunity. The RMF manages the tort liability of the State, its agencies' employees, and the University System. All State agencies participating in the RMF and their fund contribution was determined using a projected cost allocation approach. The statutory liability of the State is limited to a total of \$250,000 per person and \$1,000,000 per occurrence.

The Office of Attorney General also participates in the North Dakota Fire and Tornado Fund and the State Bonding Fund. The office pays an annual premium to the Fire and Tornado Fund to cover property damage to building and personal property. Replacement cost coverage is provided by estimating replacement cost in consultation with the Fire and Tornado Fund. The Fire and Tornado Fund is reimbursed by a third party insurance carrier for losses in excess of \$1 million per occurrence during a 12 month period. The State Bonding Fund currently provides the agency with blanket employee fidelity bond coverage in the amount of \$2,500,000. The State Bonding Fund does not currently charge any premium for this coverage.

**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING
AND ON COMPLIANCE BASED ON AN AUDIT OF FINANCIAL
STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Honorable John Hoeven, Governor
Members of the Legislative Assembly

Chuck Keller, Director
North Dakota Lottery

We have audited the financial statements of the business-type activities of the North Dakota Lottery, as of and for the year ended June 30, 2004, which collectively comprise the North Dakota Lottery's basic financial statements and have issued our report thereon dated September 30, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the North Dakota Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance that is required to be reported under *Government Auditing Standards* as described in the accompanying schedule of findings, recommendations and agency response.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the North Dakota Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the North Dakota Lottery's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable condition is described in the accompanying schedule of findings, recommendations and agency response.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness. We also noted other matters involving the internal control over financial reporting that we have reported to management of the North Dakota Lottery, in a separate letter dated September 30, 2004.

This report is intended solely for the information of the Governor, Legislative Audit and Fiscal Review Committee, and management of the North Dakota Lottery and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Robert R. Peterson
State Auditor
September 30, 2004

NORTH DAKOTA LOTTERY

SPECIAL COMMENTS REQUESTED BY THE LEGISLATIVE AUDIT AND FISCAL REVIEW COMMITTEE

For The Year Ended June 30, 2004

The Legislative Audit and Fiscal Review Committee requires that certain items be addressed by auditors performing audits of state agencies. These items and our responses are as follows:

1. Were expenditures made in accordance with legislative appropriations and other state fiscal requirements and restrictions?

The North Dakota Lottery has a continuing appropriation, per section 53-12-19 of the North Dakota Century Code.

2. Were revenues accounted for properly?

Yes.

3. Were there adequate financial controls and procedures?

Yes.

4. Was the system of internal control adequate and functioning effectively?

Other than our finding addressing the "computer access control weakness" (see page 24), we determined internal control was adequate.

5. Do financial records and reports reconcile with state fiscal offices?

Yes.

6. Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?

Other than our finding addressing "depositing revenue into the state treasury" (see page 25), the North Dakota Lottery was in compliance with significant statutes, laws, rules, and regulations under which it was created and is functioning.

7. Was there any indication of fraud or dishonesty?

No.

8. Were there any indications of lack of efficiency in financial operations and management of the agency?

No.

9. Has action been taken on findings and recommendations included in prior audit reports?

This is the first audit of this entity.

10. Were all activities of the agency encompassed within appropriations of specific amounts?

The North Dakota Lottery has a continuing appropriation, per section 53-12-19 of the North Dakota Century Code.

11. Has the agency or institution implemented the Statewide Accounting and Management Information System (SAMIS) including the cost allocation system?

Yes. The North Dakota Lottery is using the SAMIS system, but is not using the cost allocation system because the North Dakota Lottery does not receive any federal funds.

12. Has the agency developed budgets of actual anticipated expenditures and revenues on at least a quarterly basis and compared on at least a quarterly basis actual expenditures and revenues on the accrual basis to budgeted expenditures and revenues?

Yes.

FINDINGS, RECOMMENDATIONS AND AGENCY'S RESPONSE

For the Fiscal Year Ended June 30, 2004

Computer Access Controls Weakness

Access controls over the Games Management System (GMS) are not adequate. All employees of the North Dakota Lottery have access to process checks and work with retailer accounts (including processing retailer credits) in the GMS, regardless of whether their job duties require that access.

Proper internal control dictates that access to computer systems should be limited only to those who need that access to perform their duties. In addition, personnel should only have access to the computer screens necessary to perform their duties. Without proper access controls, personnel have the opportunity to bypass many important controls, especially segregation of duties. Therefore, there is an increased risk of unauthorized transactions and a greater chance of corruption of data.

Recommendation:

We recommend access privileges for the Games Management System be restricted to necessary individuals.

Agency Response:

Depositing Revenue into the State Treasury

The North Dakota Lottery is not depositing all revenues from the sale of lottery tickets into its operating account within the state treasury in accordance with section 53-12-19 of the North Dakota Century Code (NDCC). The revenues collected by the retailers, less their commissions and the prizes paid directly by them, are transferred from the retailer accounts into an account at the Bank of North Dakota from which the Lottery makes payments to prize winners. This account was also used to make two payments to the Multi-State Lottery Association (MUSL). The amount of money needed to cover the prize liability is left in the prize payment fund and the remainder is then transferred into the operating fund in the state treasury.

Section 53-12-19 of the NDCC requires all revenues from the sale of lottery tickets to be deposited into the Lottery's operating account within the state treasury. That section further authorizes the disbursements from the operating fund which includes the payment of prizes. Since the Lottery does not deposit into its operating fund that portion of the ticket sales revenue that is needed to cover prize payments and also made payments to MUSL directly from the BND account, the Lottery is not in compliance with the NDCC.

Recommendation:

We recommend the North Dakota Lottery deposit all revenues from the sales of lottery tickets (less retailer commissions and prizes paid by retailers) into the operating fund within the state treasury as required by state law.

Agency Response: